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Supreme Court, U.S.
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No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

W. H. PLANT, JR. and DORIS D. PLANT,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE ELEVENTH CIRCUIT

PETITION FOR CERTIORARI

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QUESTION PRESENTED

The question presented is whether payments received in advance of cutting under a long-term timber cutting contract, which are to be credited in payment of timber cut in subsequent years, qualify for capital gain treatment under federal income tax laws. Those laws provide capital gain treatment for timber sold under a contract by which the taxpayer has retained an "economic interest" in the timber.

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OPINIONS BELOW

The opinion of the Court of Appeals is reported in 682 F.2d 914, and appears in the appendix hereto at pages A-1 et. seq. The order denying petition for rehearing appears in the appendix hereto at pages A-8. The order and memorandum of decision of the District Court for the Northern District of Alabama is reported at 48 AFTR 2d 81-5936 (1981) and appears in the appendix hereto at pages A-9 et. seq.

JURISDICTION

The judgment of the Court of Appeals for the Eleventh Circuit was entered on August 9, 1982 by a divided panel. A timely petition for rehearing was denied on October 14, 1982, and

this petition for certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254 (1).

STATUTES AND REGULATIONS INVOLVED

This case arises under the 1954 Internal Revenue Code and Income Tax Regulations, *viz.*: 26 U.S.C. §§ 631 (b), 631 (c) and 1231; and 26 C.F.R. §§ 1.611-1 (b), 1.631-2 and 1.631-3, which are set forth in the appendix at A-17 et. seq.

STATEMENT OF THE CASE

On February 21, 1967, the petitioners ("taxpayers") entered into a Timber Sales Contract ("contract") with Hammermill Paper Company covering approximately 2,394 acres situated in Lowndes County, Alabama. The taxpayers agreed to sell and Hammermill agreed to purchase all timber standing and growing on taxpayers' land during the term of the contract. The contract expires on December 31, 1987 unless renewed by Hammermill for ten years. The contract provides that Hammermill will pay a specified price per cord for timber cut by it.

Hammermill is obligated to pay taxpayers each year for at least 2,000 pine cords or its equivalent in sawtimber in quarterly installments. Payment for timber cut in excess of 2,000 cords in any particular year is to be made at the end of such year. In the event Hammermill cuts less than 2,000 cords in a year, it pays for 2,000 cords but has the right to cut at any time prior to the expiration of the contract the timber paid for in advance. Upon termination of the contract, Hammermill's right and obligation to cut timber expires, and taxpayers retain as liquidated damages for failure to cut timber any advance payments which have not been credited against timber cut.

In calculating amounts due taxpayers under the contract, timber cut and removed by Hammermill is measured after it has been cut. Payment is made to taxpayers based on the number of pine cords cut and removed at the unit prices specified in the contract. In 1969, 1971 and 1972, an aggregate of 5,246

pine cords was cut and removed. In 1972 Hammermill cut 2,697 cords of which 697 cords were paid for by application of advance payments made in prior years.

The taxpayers received advance payments under the contract during the years 1973, 1974 and 1975. These advance payments were to be applied as payment for timber cut in subsequent years since no timber was cut during these years. The taxpayers reported these payments as long term capital gains pursuant to 26 U.S.C. §§ 631 (b) and 1231 and 26 C.F.R. § 1.631-2 (d). The Internal Revenue Service disallowed capital gain treatment for these advance payments because there was no guarantee that timber paid for in advance would be cut in subsequent years. The taxpayers paid the additional taxes, filed claims for refund which were disallowed and suit was filed in the District Court for the Northern District of Alabama. Jurisdiction of the District Court is conferred by 28 U.S.C. § 1291.

The District Court concluded that the decision in *Crosby v. United States,* 414 F.2d 822 (5th Cir. 1969), mandated that the advance payments were not entitled to capital gain treatment. A majority of the panel in the Court of Appeals also concluded that the decision in *Crosby v. United States, supra,* mandated such a result. The dissenting Judge on the panel in the Court of Appeals below distinguished *Crosby* on the grounds that the taxpayer in *Crosby* did not bring to that Court's attention the recomputation feature of the regulation which clearly contemplates that all timber paid for in advance may not be cut.

REASONS FOR GRANTING THE WRIT

1. The two-to-one panel decision below conflicts with decisions of this Court and other Courts of Appeal which have held that payments or royalties paid in advance for production of property do not preclude the retention of an "economic interest" in such property.

A taxpayer who enters into an oil and gas or other mineral lease and is paid on the basis of production realizes ordinary

income and is entitled to depletion because the taxpayer has retained an economic interest in the mineral. 26 U.S.C. § 611 and 26 C.F.R. § 1.611-1. On the other hand, a taxpayer who disposes of timber, coal or iron ore and retains an economic interest therein is entitled to capital gain under 26 U.S.C. §§ 631 and 1231 but is not entitled to depletion. 26 C.F.R. § 1.611-1 (b) (2). In each instance, the tax consequence turns on whether the taxpayer has an economic interest in the minerals or timber. The term "economic interest" is defined in 26 C.F.R. § 1.611-1 (b) (1) as follows:

> "(b) *Economic interest.* — (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. . . ."

This regulation is based on the definition of an economic interest for depletion purposes established by the Supreme Court in *Commissioner v. Southwest Explorations Co.*, 350 U.S. 308, 314 (1956). It is very clear from the regulations that the same concept of economic interest is applicable for capital gain purposes under 26 U.S.C. § 631 (b). Thus, 26 C.F.R. § 1.611-1 (b) (2) provides as follows:

> (2) No depletion deduction shall be allowed the owner with respect to any timber, coal or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal or iron ore, if such disposal is considered a sale of timber, coal or domestic iron ore under section 631 (b) or (c).

Thus, a taxpayer that disposes of timber, coal or iron ore with a retained economic interest is entitled to either depletion or capital gain, but not both. In any event such a taxpayer is not entitled to either capital gain or depletion unless he has an

economic interest in the mineral. 26 C.F.R. § 1.611-1 (b). The Supreme Court in *Herring v. Commissioner,* 293 U.S. 322 (1934), made it clear that an economic interest was retained and depletion was allowable whether or not there was production during the year royalties were received. In *Engle v. Commissioner,* 677 F. 2d 594 (7th Cir. 1982), the Seventh Circuit discussed the law relating to depletion and economic interest for oil and gas as it existed prior to 1975. In that year, the law with respect to oil and gas depletion was changed, but there was no change with respect to other minerals or timber. As stated in *Engle,* the Supreme Court has made it clear that if depletable properties result in gross income to the taxpayer, the depletion allowance is applicable [and an economic interest is retained] whether or not any physical extraction occurs during the taxable year.

This Court has held repeatedly that, for economic interest and depletion purposes, advance payments are not to be treated any differently than a payment based upon production. *Herring v. Commissioner,* 293 U.S. 322 (1934); *Burnet v. Harmel,* 287 U.S. 103 (1932). The Courts of Appeal have reached the same result in mineral cases. *Wood v. United States,* 377 F. 2d 300 (5th Cir. 1967), *cert. denied,* 389 U.S. 977; *Freund v. United States,* 367 F. 2d 776 (7th Cir. 1966); *Laudenslager v. Commissioner,* 305 F. 2d 686, 691 (3rd Cir. 1962).

In *Burnet v. Harmel, supra,* the taxpayer executed an oil and gas lease for a bonus paid in advance of production and royalties based on production. The taxpayer asserted that the transaction was a sale of the mineral in place because the bonus was to be retained regardless of production. The Government treated the transaction as a lease of the minerals giving rise to ordinary income subject to depletion on the grounds that the bonus did not indicate it was a sale of the minerals. The bonus was treated the same as production royalty even though the bonus was to be retained regardless of production. In holding for the Government, the Supreme Court said:

> "Bonus and royalties are both consideration for the lease and are income to the lessor. We cannot say that such pay-

ments by lessee or lessor, to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by actual production."

The Supreme Court has also established that if no production of oil or gas occurred prior to the cancellation of the lease, the taxpayer was required to restore the previously deducted depletion to income. *Douglas v. Commissioner,* 322 U.S. 275, 285 (1944). This principle has been applied with respect to timber in 26 C.F.R. § 1.631-2 (d) (2) and is the regulation on which the taxpayers rely in this case.

Whenever a contract for the disposal of minerals or timber provides for an advance payment which is to be retained regardless of production, there is always the possibility that the owner of the minerals or the timber may receive payment without extraction of minerals or severance of timber. The income tax regulations on timber and minerals have always recognized this possibility.[1] In the mineral cases, the Government has always argued that an advance payment that may be forfeited does not preclude the retention of an economic interest, and this Court and the Courts of Appeal have upheld that position.

The majority of the panel in the decision below acknowledged in footnote 12 of its opinion that it could not follow the principles established by the Supreme Court in the mineral cases because they felt bound by the decision of the Fifth Circuit in *Crosby v. United States,* 414 F. 2d 822 (5th Cir. 1969). The case law of the Fifth Circuit has been adopted by the Eleventh Circuit as binding precedent unless overruled or modified by the Eleventh Circuit sitting *en banc. Bonner v. City of Pritchard,* 661 F. 2d 1206 (11th Cir. 1981). However, the decision of the Fifth Circuit in *Crosby* directly conflicts with the decisions of the Supreme Court which have held that advance payments which are to be retained regardless of production do not preclude the retention of an economic interest.

Subsection (c) of 26 U.S.C. § 631, providing capital gain for

[1] 26 C.F.R. § 1.631-2 (d); 26 C.F.R. § 1.631-2 (d) (3) (iv); 26 C.F.R. § 1.631-3 (c) (2); 26 C.F.R. § 1.631-3 (c) (3).

the disposal of coal and iron ore with a retained economic interest, is virtually identical to subsection (b) of 26 U.S.C. § 631, providing capital gain treatment for the disposal of timber with a retained economic interest. The regulations relating to advance payments in coal or iron ore leases (26 C.F.R. § 1.631-3) are identical with 26 C.F.R. § 1.631-2(d) relating to advance payments in timber cutting contracts. The Government continues to issue private rulings which approve capital gain treatment for advance payments under coal leases which do not guarantee that all coal paid for in advance will be mined. Private Ruling Letter 8014080.

There is no basis in the applicable statutes, legislative history, regulations or decisions of the Supreme Court which authorizes the Internal Revenue Service, for purposes of determining whether an economic interest has been retained, to treat advance payments under timber cutting contracts differently than advance payments under mineral leases. This Court has held repeatedly for more than thirty years that advance payments in mineral leases do not preclude retention of an economic interest.

2. The two-to-one panel decision below is in direct conflict with 26 C.F.R. § 1.631-2(d) which provides capital gain treatment for advance payments made under timber cutting contracts.

The gain from timber disposed of in accordance with 26 U.S.C. § 631(b) is taxable as capital gain under 26 U.S.C. § 1231. The Hammermill contract constitutes a disposal of timber by taxpayers with a retained economic interest within the meaning of 26 U.S.C. § 631(b). The timber is sold on the stump, is cut by Hammermill, is measured after cut and payment is made to taxpayers based on the number of cords cut. This is exactly the type of timber cutting contract which the Congress intended to qualify for capital gain treatment. Prior to the enactment in 1943 of the predecessor to 26 U.S.C. § 631(b), the Government had contended that payments under a timber cutting contract were ordinary income subject to de-

pletion because the owner of the timber had retained an economic interest in the timber. Sen. Rep. 627, 78th Cong., 1st Sess., p. 25-26, 1944 Cum. Bull. 973, 993. Thus, by the enactment of the predecessor to § 631 (b) the Congress intended that payments under a timber cutting contract which previously had been treated as ordinary income subject to depletion were to be taxed as capital gain.

In this case the payment for at least 2,000 cords each year is an advance payment expressly entitled to capital gain treatment under 26 C.F.R. § 1.631-2 (d), which provides that payments received in advance of cutting are entitled to capital gain treatment if the contract provides that such amounts are to be applied as payment for timber subsequently cut. It further provides that if timber paid for in advance is not cut the taxpayer shall recompute his tax liability. Thus, 26 C.F.R. § 1.631-2 (d) provides as follows:

> "(d) *Payments received in advance of cutting.* (1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631 (b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Such amounts will be so treated irrespective of whether or not an election has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if no election has been made under paragraph (c) of this section, amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than six months after the date of acquisition of such timber.
>
> "(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631 (b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall

be made in the form of an amended return where necessary."

Nevertheless, in footnote 11 of the opinion in the Court of Appeals, the majority held that subsection 2 (d)(1) of the regulation applies only to advance payments received under a contract which guarantees that timber paid for in advance will be cut at a subsequent date, referring to *Crosby v. United States*, 414 F. 2d 822 (5th Cir. 1969). There is no language in subsection 2 (d) (1) requiring such a guarantee. The only requirement of the subsection is that the contract must provide that advance payments are to be applied as payment for timber subsequently cut. The Hammermill contract specifically does so.

Subsection 2 (d) (2) expressly contemplates that timber paid for in advance may not be cut, otherwise there would be no need for the recomputation provision. The dissenting opinion in the decision below states that subsection 2 (d) (2) cannot be reconciled with the interpretation of subsection 2 (d) (1) by *Crosby v. United States, supra*, which added the requirement of a guarantee of future cutting. The express purpose of subsection 2 (d) (2) is to provide for the situation in which the right to cut timber paid for in advance expires or terminates before the timber is cut.

The majority opinion in the Court of Appeals recognizes that the possibility of timber being paid for and left standing is remote. Subsection 2 (d) (2) provides that an advance payment is to be denied capital gain treatment only if and when the right to cut expires, terminates or is abandoned. It would be grossly unfair, unintended by the tax laws and contrary to the regulation to deny the taxpayers forever the right to § 631 (b) treatment before the right to cut their timber expires. The effect of the majority opinion below is to deny capital gain treatment for a payment made in one year even though it is applied in payment for timber cut in the immediately succeeding year. The purpose of the regulation is to prevent precisely this result.

Subsection 2 (d) (2) of the regulation specifically refers only to the "right" to cut timber and makes no reference to an obligation to cut or to a guarantee that all timber paid for in ad-

vance will be cut. Even if the contract contained an express obligation to cut all timber paid for in advance, there would still be no guarantee that the purchaser would do so. The only way to determine whether advance payments are applied in payment for timber subsequently cut is to wait until the right to cut expires, which is exactly what subsection 2 (d) (2) provides.

The Fifth Circuit in *Crosby* did not make any analysis or comment with respect to subsection 2 (d) (2) of the regulation, even though subsection 2 (d) (2) deals specifically with the tax treatment of advance payments for timber which is not cut. As pointed out in the dissenting opinion below, the decision of the Fifth Circuit in *Crosby* is directly in conflict with the regulation. That regulation was issued in 1957 and was relied upon by this taxpayer and many other timberland owners when entering into cutting contracts. These timberland owners would not have entered into long-term cutting contracts with advance payments except for the regulation and the decisions of the Supreme Court in *Herring, Burnet v. Harmel, Douglas* and others.

3. The income taxation of advance payments under long-term timber cutting contracts is of national importance because such contracts are essential to the continued development of the forest products industries in this country.

Available published statistics reflect that in 1970 there were 526 timber cutting contracts in the South covering 1,281,495 acres with an average of 2,436 acres per contract.[2] Timber is a very important national resource. In the South there are 199,947,700 acres of commercial timberland of which 36,500,000 acres are owned by the forest industry, 61,398,000 acres are owned by farmers and 83,423,000 acres are owned by other pri-

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[2] *William C. Seigle,* "Long Term Contracts for Forestlands and Timber in the South", U.S. Department of Agriculture, Forest Service Research Paper 50-87 1973.

vate owners.[3] In 1977 the South produced 45% of the national timber harvest and it is expected to be the major producer in the future.[4]

Long term cutting contracts are a significant factor in the development of commercial timberlands.[5] They enable landowners to retain ownership of timberlands and at the same time give lumber and paper manufacturers access to the timber during the extended term of the contract. It is reasonable to assume that most if not all of these contracts provide for advance payments as do oil, gas and mineral leases. All the parties to these contracts expected capital gain treatment pursuant to 26 C.F.R. § 1.631-2(d) which was based on the decisions of the United States Supreme Court and other Courts of Appeal in mineral cases. The decision in this case will be of great importance to these timberland owners and to the continued development of the timberlands and the forest products industries in this country. In view of the direct conflict between the decision below and the decisions of the United States Supreme Court in *Herring, Burnet v. Harmel, Douglas* and *Southwest Exploration Co.* and the decisions of the Courts of Appeals in the mineral cases, this matter deserves consideration by this Court.

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[3]*An Assessment of the Forest and Range Land Situation in the United States,* Forest Service, U.S. Department of Agriculture, January, 1980, FS 345, A13.2: F 76186, Pages 45 and 366.

[4]*Fact Book of U.S. Agriculture,* November, 1981 U.S. Department of Agriculture, Misc. Pub. No. 1062, A1.38: 1063/8.

[5]*William C. Seigle,* "Long Term Contracts for Forestlands and Timber in the South", U.S. Department of Agriculture, Forest Service Research Paper 50-87 1973.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinions of the Eleventh Circuit.

Respectfully submitted,

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W. H. PLANT, Jr., and Doris D. Plant,
Plaintiffs-Appellants,

v.

UNITED STATES of America,
Defendant-Appellee.

No. 81-7541.

United States Court of Appeals,
Eleventh Circuit.

Entered: Aug. 9, 1982.

Appeal from the United States District Court for the Northern District of Alabama.

Before GODBOLD, Chief Judge, MERRITT*, and HENDERSON, Circuit Judges.

In this tax refund suit the appellants seek a capital gain for proceeds received under the terms of a timber sale contract. The district court granted the government's motion for summary judgment, concluding that the decision in *Crosby v. United States*, 414 F.2d 822 (5th Cir. 1969) mandated such a result.[1] We agree with the district court and affirm.

In 1967, the appellants agreed to sell to Hammermill Paper Company (Hammermill) all the timber standing and growing on 2,394 acres of land for a period of twenty years.[2] The agreement provides that Hammermill pay for the timber according to a base price per cord[3] and obligates Hammermill to pay for at least 2,000 cords per year regardless of the actual annual

*Honorable Gilbert S. Merritt, U. S. Circuit Judge for the Sixth Circuit, sitting by designation.

[1]The case law of the former Fifth Circuit Court of Appeals has been adopted by the Eleventh Circuit Court of Appeals as binding precedent unless and until overruled or modified by this court sitting *en banc*. *Bonner v. City of Prichard*, 661 F.2d 1206 (11th Cir. 1981) (*en banc*).

[2]The contract expires on December 31, 1987 with an option to renew for an additional ten years. Record at 39.

[3]The price per cord depends on the type of wood and fluctuates according to the change in the Wholesale Price Index for All Commodities.

harvest. If Hammermill cuts more than 2,000 cords in any one year, the compensation for the excess is payable at the end of the year. In the event less than the guaranteed minimum is severed, a "timber backlog" clause authorizes Hammermill to harvest the timber paid for in advance at any time prior to the expiration of the contract when the right to cut expires and the taxpayers retain as "liquidated damages" advance payments not credited against the timber yield.[4]

In 1973, 1974 and 1975, the Plants received a total of $47,391.38 in accordance with the terms of the contract and reported the income as capital gains pursuant to 26 U.S.C. § 631(b).[5] When the Internal Revenue Service disallowed this relief, the taxpayers paid additional taxes and filed this suit for a refund.

Section 631(b) provides that income received under a timber sale contract may be regarded as capital gains from a sale of timber if timber which has been held more than twelve months is disposed of by the owner, who must retain an economic interest in the trees. 26 U.S.C. § 631(b).[6] The sole issue

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[4]The contract also stipulates that the Plants are required to pay all taxes on the land, including *ad valorem* taxes and improvement assessments. While Hammermill may use the property in any manner necessary to facilitate harvesting, the Plants retain free access for any purpose not inconsistent with Hammermill's rights. The taxpayers retain title in the timber until it is cut so that if the trees become unmerchantable before harvesting, the landowners bear the loss.

[5]Although the district court stated in its memorandum opinion that no timber was cut during the years in issue, Record at 60, the record is silent in that respect. As our analysis below indicates, however, this variance makes no difference because the proceeds involved here represent only minimum annual payments. If payments had been made for timber harvested in excess of the 2,000-cord minimum, such income would clearly qualify for capital gains treatment under § 631(b). *See* note 9, *infra*.

[6]At the time of the execution of the contract, 26 U.S.C. § 631(b) read, in relevant part:

> In the case of the disposal of timber held for more than 6 months before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber.

in this appeal is whether the Plants retained an economic interest in the timber in light of the possibility that Hammermill will not harvest all of the trees paid for in advance before the expiration of the contract period, thus entitling the Plants to retain payments for timber not actually severed from the land.[7] If the taxpayers did not retain an economic interest, section 631 (b) does not control and the proceeds must be considered as ordinary income.[8]

The tax regulations provide that

> [a]n economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in . . . standing timber and secures, by form of legal relationship,

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In 1976, this section was amended to require that the timber be held for more than one year.

"[T]imber . . . with respect to which § 631 applies" is referred to in 26 U.S.C. § 1231 (b) as "property used in the trade or business." Proceeds from the sale of such property are treated as capital gains by § 1231 (a).

[7]The capital gains treatment for qualifying taxpayers under § 631 and § 1231, see note 6, *supra*, was accorded legal force in order to prevent the hardship to taxpayers and the timber industry caused by the necessity of reporting a large amount of ordinary income in the year of harvesting which could not be spread over the years of growth during which time operating expenses continued. *United States v. Brown Wood Preserving Co.*, 275 F.2d 525 (6th Cir. 1960). In 1943, Congress enacted the predecessor to § 631 (b) in recognition of the fact that owners who dispose of their timber by means of a cutting contract under which they retain an economic interest should have the same tax advantages as those who sever their own timber. S.Rep.No.627, 78th Cong., 1st Sess. In essence, the Plants seek tax advantages designed to compensate for fluctuating proceeds as well as guaranteed annual income from the sale of timber.

[8]Title 26 U.S.C. § 1221, which considers proceeds from the sale of a capital asset held for investment purposes as capital gains, affords taxpayers more favorable treatment for earnings up to the fair market value of timber standing at the time of the execution of the contract. *Crosby*, 414 F.2d 822. Timber not standing at the time the agreement was made, however, cannot be a capital asset under § 1221. *Dyal v. United States*, 342 F.2d 248, 252 (5th Cir. 1965). In addition, regardless of whether the sale meets the criteria of § 1231 and § 631 (b), the proceeds may still be recognized as capital gains under the general provisions of § 1231 if the timber qualifies as property used in a trade or business. *Dyal*, 342 F.2d at 251, 252. Here, the Plants did not argue to either the district court or this court that their situation fits into either category.

> income derived from . . . the severance of the timber, to which he must look for a return of his capital.

26 C.F.R. § 1.611-1.[9] In *Dyal v. United States*, 342 F.2d 248 (5th Cir. 1965), the taxpayers sought to qualify for favorable treatment under § 631 (b) where the contract specified the payment of fixed amounts annually without regard to the amount of timber cut. The court explained that for taxpayers to retain an economic interest, "[i]t is essential that the consideration for the transaction . . . be contingent upon the severance of the timber, and payable to the owner solely out of the proceeds from the natural resource itself." *Dyal*, 342 F.2d at 252 (footnote omitted). The taxpayers retained no economic interest because

> [t]hey were not required to look to the sale or severance of the timber for the annual payments, and the obligation of [the purchaser] to make the annual payments . . . was in no way determined or affected by the amount of timber cut, or whether any timber was cut at all.

Dyal, 342 F.2d at 252.

In *Crosby*, 414 F.2d 822, the court elaborated on the *Dyal* rationale in a factual setting very comparable to this controversy. There, the purchaser was obligated to make minimum annual payments which entitled it to cut a prescribed number of cords each year. Timber so purchased but not severed went into a "timber backlog" which the purchaser could cut without making further payments. After reciting the definition of a retained economic interest enunciated in *Dyal*, the court went on to hold that there could be no retained interest unless *all* of the minimum annual payment is *necessarily* contingent upon the severance of the timber:

> Significantly, even if these restrictions [on the right to cut the backlog] were met, the agreement does not obligate

[9] For example, the Plants clearly retain an economic interest in timber harvested over the 2,000-cord yearly minimum. Since such excess cutting must be compensated for on a price per cord basis, there is no possibility that Hammermill will pay for timber left standing. *See Dyal*, 342 F.2d at 252 (5th Cir. 1965).

> [the purchaser] to exercise its backlog privilege. Consequently it is possible for the taxpayers to receive their payments without a single tree ever being cut. This possibility clearly demonstrates that the payments are not contingent upon the severance of the timber. Finally, the contract provides that upon termination all timber not cut and removed remains the property of the taxpayers even if [the purchaser] had previously made advance payments for the timber.

Crosby, 414 F.2d at 825. The court took note of Title 26 C.F.R. § 1.631-2(d),[10] which extends capital gains treatment of advance payments if the taxpayer retains an economic interest, but rejected its relevance where there is "simply no guarantee that the timber will ever be cut." *Crosby*, 414 F.2d at 825.[11]

We find no real difference between this contract and the one

---

[10]Title 26 C.F.R. § 1.631-2(d) provides that

> (1) Where the conditions of paragraph (a) of this section are met [the timber is held for more than one year and the taxpayer retains an economic interest] amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631(b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut . . .
>
> (2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631(b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

[11]The Plants point out that, after *Crosby*, it is difficult to conceive of a situation in which the language of subsection 2(d)(2) will have any meaning because that regulation comes into play only when an economic interest is retained and *Crosby* would preclude any such interest in a factual situation covered by 2(d)(2) (the possibility of a non-refundable overpayment). The *Crosby* court obviously did not consider the effect of 2(d)(2) because its applicability is premised on 2(d)(1). The court held that 2(d)(1) governs only advance payments received for timber which the contract *guarantees* will be cut at a subsequent date. Here, as in *Crosby*, there is no such contractual requirement. For that reason, subsection 2(d)(1), and hence 2(d)(2), have no significance.

before the *Crosby* court.[12] It is true that the *Crosby* contract contained more significant restrictions on the purchaser's ability to cut its timber backlog. The *Crosby* court made it clear, though, that the mere *possibility* that the backlog would not be cut was the bedrock of its decision. While such a likelihood may be more remote here, it is plainly a part of the contract. The Plants also call attention to the fact that their contract, unlike the *Crosby* agreement, anticipates that the backlog might not be harvested before the expiration of the contract, and thus enables them to retain the prior payments as "liquidated damages for [Hammermill's] failure to cut the timber." Record at 34. The use of these words of art does not alter the fact that both the *Crosby* contract and the Plant agreement permit the landowners to retain the consideration previously paid thereunder at the end of the contract term without obligating them to make a refund for the uncut timber. In reality, it is a guaranteed annual income for the Plants for the life of the contract, precisely the type of arrangement foreclosed by *Crosby*.

For the foregoing reasons, the judgment of the district court is

AFFIRMED.

MERRITT, Circuit Judge, dissenting:

It seems to me that 26 C.F.R. § 1.631-2(d), quoted in footnote 10 of the Court's opinion, is applicable to the timber con-

[12]Although the Plants attempt to distinguish *Crosby*, they also take issue with the correctness of the decision, contending that the legislative history of § 631(b) refutes its rationale. The term "retained economic interest" first appeared in cases in which the issue was whether the taxpayers received the proceeds from the outright sale of oil and gas or if the income was the result of a disposition by which there was a retained economic interest in the minerals. While the Plants admit that the tax consequences in the oil and gas area are different (a taxpayer with a retained economic interest in oil and gas receives ordinary income, 26 U.S.C. § 611), they maintain that since a guaranteed income does not defeat a retained interst in oil and gas, *Burnet v. Harmel*, 287 U.S. 103, 53 S.Ct. 74, 77 L.Ed.2d 199 (1932), Congress intended a similar result when it used the phrase with respect to timber. As stated earlier, we are bound by *Crosby*. *See* note 1, *supra*.

tract in question here. Thus, the "amounts received [by the taxpayer] prior to cutting" under subsection 2 (d) (1) should be treated as capital gains subject to recomputation as ordinary income under subsection 2 (d) (2) if the contract ends "before the timber which has been paid for is cut." The *Crosby* case relied upon by the court did not specifically consider and analyze subsection 2 (d) (2), and I would distinguish it on the ground that the taxpayer in *Crosby* did not bring to the court's attention the recomputation feature of the regulation, a feature that clearly contemplates that all the timber paid for may not be cut. The court in *Crosby* was, therefore, led to believe that the statute and regulation in question contemplate as a decisive test of capital gains treatment the cutting of all the timber. Subsection 2 (d) (2) cannot be reconciled with such an interpretation. The *Crosby* court did not reach a considered decision based on an analysis of all the law applicable to the facts, namely subsection 2 (d) (2). The *Crosby* case should be distinguished because the court there did not consider the main argument concerning the applicability of subsection 2 (d) (2) presented by the taxpayer here.

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 81-7541

W. H. PLANT, JR., and DORIS D. PLANT,
Plaintiffs-Appellants,

versus

UNITED STATES OF AMERICA,
Defendant-Appellee.

(Entered October 14, 1982)

Appeal from the United States District Court for the Northern District of Alabama

ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Opinion August 9, 11 Cir., 1982, ... F.2d .....).

Before GODBOLD, Chief Judge, MERRITT* and HENDERSON, Circuit Judges.

PER CURIAM:

The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Eleventh Circuit Rule 26), the suggestion for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ ALBERT J. HENDERSON
United States Circuit Judge

*U.S. Circuit Judge, 6th Circuit Court of Appeals, sitting by designation.

IN THE UNITED STATES DISTRICT COURT FOR
THE NORTHERN DISTRICT OF ALABAMA
SOUTHERN DIVISION

W. H. PLANT, JR.,	)	
DORIS D. PLANT,	)	
PLAINTIFFS	)	
VS.	)	CIVIL ACTION NO.
UNITED STATES OF	)	79-HM-1340-S
AMERICA,	)	
DEFENDANT	)	

(Entered April 28, 1981)

ORDER

This cause came on for consideration by the court on the cross motions for summary judgment filed by the plaintiffs and the defendant seeking summary judgment in their respective favors with regard to all issues involved in the above entitled action.

Having considered the respective motions for summary judgment, the evidentiary matter offered in support of and in opposition thereto, the pleadings and briefs of counsel, and having heard counsel in oral argument, the court is of the opinion that plaintiffs' motion for summary judgment is due to be denied and that defendant's motion for summary judgment is due to be granted. The court expressly determines that there is no genuine issue as to any material fact with respect to plaintiffs' claims made against defendant in the above entitled civil action, that the defendant is entitled to judgment as a matter of law with respect to plaintiffs' claims made in this action against defendant, and that there is no just cause or reason for delay in entry of final judgment in favor of defendant.

Accordingly, in conformity with the Memorandum of Decision filed contemporaneously in this cause, it is

ORDERED, ADJUDGED and DECREED that plaintiffs' motion for summary judgment in their favor in the above entitled civil action be and the same hereby is DENIED.

FURTHER ORDERED, ADJUDGED AND DECREED that defendant's motion for summary judgment in its favor with respect to plaintiffs' claims made against defendant in the above entitled civil action be and the same hereby is GRANTED and that summary judgment be and the same hereby is ENTERED herein in favor of defendant with respect to plaintiffs' claims made against defendant in the above entitled civil action.

FURTHER ORDERED, ADJUDGED and DECREED that plaintiffs W. H. Plant, Jr. and Doris D. Plant have and recover NOTHING of the defendant United States of America in the above entitled civil action and that the costs in this cause be and the same hereby are taxed against plaintiffs, for which let execution issue.

DONE and ORDERED this 28th day of April, 1981.

/s/ E. B. HALTOM, JR.

E. B. HALTOM, JR.
UNITED STATES DISTRICT JUDGE

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ALABAMA SOUTHERN DIVISION

W. H. PLANT, JR.,	)	
DORIS D. PLANT,	)	
PLAINTIFFS	)	
VS.	)	CIVIL ACTION NO.
UNITED STATES OF	)	79-HM-1340-S
OF AMERICA,	)	
DEFENDANTS	)	

(Entered April 28, 1981)

MEMORANDUM OF DECISION

This is a tax refund suit in which the plaintiffs claim they are entitled to capital gain treatment of proceeds received from a Timber Sale Contract.

This cause came on for consideration by the court on the cross motions for summary judgment filed by the plaintiffs and the defendant seeking summary judgment in their respective favors with regard to all issues involved in the above entitled action. By filing their motions for summary judgment, the parties herein have represented to the court that there is no genuine issue as to any material fact with regard to the issues here presented.

The court has before it plaintiffs' complaint and the exhibits made a part thereof, answer of defendant essentially admitting all allegations of fact made in the complaint but expressly denying that any taxes were erroneously or illegally assessed or collected from plaintiffs, affidavit of Harold J. Hill [Manager, Forest Resources and Operations, Southern Timberlands Division, Hammermill Paper Company] offered in support of plaintiffs' motion for summary judgment, and briefs of counsel. The court hereby finds the following facts established by the foregoing and proceeds to make the following conclusions of law based thereon.

On February 21, 1967, W. H. Plant, Jr. and Doris D. Plant entered into a timber sale contract with Hammermill Paper Company covering approximately 2,394 acres situated in Lowndes County, Alabama. Pursuant to the contract, the Plants agreed to sell and Hammermill agreed to purchase all the timber standing and growing during the term of the twenty year contract. Under the contract, the price of pulpwood, subject to adjustment according to the Wholesale Commodity Price Index, was $6.00 per cord for pine and $2.50 per cord for hardwood. Based on an estimated annual growth of 2,000 cords of pine pulpwood, Hammermill was obligated to pay the plaintiffs $12,000.00 annually. Payments for amounts cut in excess of the average annual growth were to be made after an annual accounting. In the event Hammermill undercut it was to pay the Plants the minimum amount but had the right to cut the timber paid for in advance at any time prior to December 31, 1987.

Although no timber was cut for the years 1973, 1974 and 1975, the Plants received as consideration under the agreement the respective payments of $14,330.75, $15,427.16 and $17,633.47. The Plants reported these payments as long term capital gains on their joint Federal income tax returns for such years. In 1977, the Internal Revenue Service disallowed capital gain treatment and the additional federal income taxes were subsequently paid by the Plants. Thereafter the Plants filed a claim for refund which was disallowed by the Commissioner and this action was subsequently filed.

The taxpayers claim that the Hammermill contract constitutes a disposal of timber by the Plants with a retained economic interest within the meaning of §631 (b) of the Internal Revenue Code of 1954, as amended (hereinafter referred to as the "Code"). That Section provides that for income to be treated as capital gain from a sale of timber, the following requirements must be satisfied:

(1) the timber must have been held by the taxpayers more than twelve months;

(2) there must have been a "disposal" of the timber; and

(3) the owner must have retained an economic interest in the timber.

In the present case, the Plants have satisfied the holding period requirement. Next, it must be determined whether there has been a "disposal" of timber. The court in *Dyalwood v. United States,* 588 F.2d 467 (5th Cir. 1979) stated that to constitute a "disposal" of timber, it is necessary that there be some indication that the taxpayer has surrendered control of the timber. According to the Fifth Circuit in *Dyalwood*:

> "Of the factors that have been considered in determining in such cases whether a disposal has been effected, the one most emphasized is who does the cutting . . . [where] the buyer enters the land and removes timber without the involvement of the seller, a stronger argument can be made that there was a prior disposal of cutting rights."

Here, under the contract with Hammermill, the Plants released all rights to cut or control cutting of the timber unless Hammermill ceased its pulpwood activity in Dallas County, Alabama.

Section 631 (b) of the Code also requires that the disposal must be "under any form or type of contract by virtue of which such owner retains an economic interest in such timber". Treasury Regulation §1.611-1 (b) (1) provides that:

> "An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber to which he must look for a return of his capital."

The Fifth Circuit in *Dyal v. United States,* 342 F.2d 248, 252 (5th Cir., 1965) stated the controlling principle in determining whether the owner retains an economic interest:

> "It is essential that the consideration for the transaction, whether payable in cash or kind, be contingent upon sever-

ance of the timber and payable to the owner solely out of the proceeds from the natural resource itself."

See also *Estate of James M. Lawton v. Commissioner* (T.C. 1959), 33 T.C. 47; Int. Rev. Rul. 62-81. Therefore, if the income generated by this agreement is not contingent upon the severance of the timber, Section 631 (b) does not apply because the taxpayers will have failed to maintain an economic interest in the timber.

Here, the Plants' agreement with Hammermill provides for a $12,000 minimum annual payment regardless of the amount of timber cut in that year. Thus, the facts of the present case are very similar to the situation in *Crosby v. United States,* 414 F.2d 822 (5th Cir. 1964). In *Crosby,* the Fifth Circuit characterized the taxpayers' payments in a similar situation as guaranteed payments which were the equivalent of rental payments and thus did not qualify for Section 631 (b) treatment. The court in that case held that the taxpayers were not entitled to treat the income generated by the Timber Purchase Agreements as capital gains since it was possible for the taxpayers to receive payments without a single tree being cut. In *Crosby* under the Timber Purchase Agreements, the Paper company was required to make payments equal to the average growth of the timber. After making those payments, the paper company was entitled to cut and remove a prescribed number of cords. Any timber so purchased and paid for, if not cut during the year of the payment became a "timber backlog" which the paper company could cut without making further payment.

Although the paper company retained a "backlog" right, the Fifth Circuit held that the agreement did not obligate the paper company to exercise its backlog privilege. Thus, the possibility that the taxpayers would receive their payments without a single tree being cut clearly demonstrated to the court that the payments were not contingent upon the severance of the timber as required. Therefore, the court held that the taxpayers were not entitled to treat the income received by the taxpayers as capital gains.

The Fifth Circuit in *Crosby* also rejected the taxpayers' contention that the annual payments involved should be treated as advance payments within Treasury Regulation §1.631-2d(1). Section 1.631-2d(1) extends capital gains treatment to advance payments received in consideration for timber subsequently cut. The court in *Crosby* in refusing to treat the annual payments in that case as advance payments within Section 1.631-2d(1) stated: "there [was] simply no guarantee that the timber would ever be cut". Thus the regulation is inapplicable here as in *Crosby* for under the Plants' agreement with Hammermill there also are no assurances that the timber would be cut.

The plaintiffs assert that there are distinctions between their contract with Hammermill and the contract in *Crosby*. In particular, the Plants assert that in *Crosby*, St. Regis could only cut the annual growth of timber, whereas Hammermill is not limited to cutting the annual timber. The Plants also argue that unlike the situation in *Crosby*, paragraph 10, as well as paragraphs 2 and 5 of the Hammermill contract obligate Hammermill to cut timber. Paragraph 10 provides that title to and risk of loss to timber remains in the Plants until the timber is cut and that:

> "In the event the damage occurs while title to the timber is in Owner, Purchaser shall be relieved of its obligation to cut the trees so damaged except as to the extent that it is economically and otherwise feasible for purchaser to cut and use or sell trees so damaged."

Despite the differences in the *Crosby* contract and the contract in the present case, the fact still remains that the Plants may receive their annual payment without a single tree being cut. In such a situation *Crosby* clearly states unless the income received is conditioned on the severance of the timber and payable solely out of the proceeds from the timber there is no retained economic interest within the meaning of Section 631(b).

For the foregoing reasons the court is of the opinion that there is no genuine issue as to any material fact and that the defendant is entitled to judgment as a matter of law.

DONE this 28th day of April, 1981.

/s/ E. B. HALTOM, JR.

E. B. HALTOM, JR.
UNITED STATES DISTRICT JUDGE

United States Code, Title 26:

SEC. 631. GAIN OR LOSS IN THE CASE OF TIMBER OR COAL.

* * *

(b) *Disposal of Timber With a Retained Economic Interest.* — In the case of the disposal of timber held for more than 1 year before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. The date of disposal of such timber shall be deemed to be the date such timber is cut, but if payment is made to the owner under the contract before such timber is cut the owner may elect to treat the date of such payment as the date of disposal of such timber. For purposes of this subsection, the term "owner" means any person who owns an interest in such timber, including a sublessor and a holder of a contract to cut timber.

* * *

(c) *Disposal of Coal or Domestic Iron Ore With a Retained Economic Interest.* — In the case of the disposal of coal (including lignite), or iron ore mined in the United States, held for more than 1 year before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal or iron ore, the difference between the amount realized from the disposal of such coal or iron ore and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal or iron ore. Such owner

shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal or iron ore. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal or iron ore, and the word "owner" means any person who owns an economic interest in coal or iron ore in place, including a sublessor. The date of disposal of such coal or iron ore shall be deemed to be the date such coal or iron ore is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535(b)(6) or section 545(b)(5). This subsection shall not apply to any disposal of iron ore –

(1) to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under section 267 or 707(b), or

(2) to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore.

* * *

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

* * *

(b) Definitions of Property Used in the Trade or Business. – For purposes of this section –

* * *

(2) Timber or coal. – Such term includes timber and coal with respect to which section 631 applies.

* * *

Code of Federal Regulations, Title 26:

SEC. 1.611-1. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(b) *Economic interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in minerals or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a more economic or pecuniary advantage derived from production. * * *

* * *

(2) No depletion deduction shall be allowed the owner with respect to any timber, coal or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal, or iron ore, if such disposal is considered a sale of timber, coal, or domestic iron ore under section 631 (b) or (c).

* * *

SEC. 1.631-2. GAIN OR LOSS UPON DISPOSAL OF TIMBER UNDER CUTTING CONTRACT.

(a) *In general.* (1) If an owner disposes of timber held for more than six months before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year. Such adjusted basis shall be computed in the same manner as pro-

vided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e) (2) of this section for definition of "owner". For the purpose of determining whether or not the timber disposed of was held for more than six months before such disposal, the rules with respect to the holding period of property contained in section 1223 shall be applicable.

* * *

(d) *Payments received in advance of cutting.* (1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631 (b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Such amounts will be so treated irrespective of whether or not an elective has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if no election has been made under paragraph (c) of this section, amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than six months after the date of acquisition of such timber.

* * *

(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631 (b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

* * *

SEC. 1.631-3. GAIN OR LOSS UPON THE DISPOSAL OF COAL OR DOMESTIC IRON ORE WITH A RETAINED ECONOMIC INTEREST.

• • •

(c) *Payments received in advance of mining.* (1) (i) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to mining shall be treated under section 631 (c) as received from the sale of coal or iron ore if the contract of disposal provides that such amounts are to be applied as payment for coal or iron ore subsequently mined. For example, advance royalty payments or minimum royalty payments received by an owner of coal or iron ore qualify under section 631 (c) where the contract of disposal grants the lessee the right to apply such royalties in payment of coal or iron ore mined at a later time.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. A acquires coal rights on January 1. On January 8, A enters into a contract of disposal providing that mining shall begin July 2, and mining actually begins no earlier. Any advance payments which A receives qualify under section 631 (c).

(2) However, if the right to mine coal or iron ore under the contract expires, terminates, or is abandoned before the coal or iron ore which had been paid for is mined, the taxpayer shall treat payments attributable to the unmined coal or iron ore as ordinary income and not as received from the sale of coal or iron ore under section 631 (c). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received. The recomputation shall be made in the form of an amended return where necessary.

(3) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631 (c) as received from the sale of coal or iron ore to the extent attributable to coal or iron ore held for more than 6 months. The rules contained in paragraph (d) of § 1.631-2

relating to bonuses in the case of contracts for the disposal of timber shall be equally applicable in the case of bonuses received for the grant of a contract of disposal of coal or iron ore under this section.

* * *

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FILED
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No. 82-1198

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

W. H. PLANT, JR. and DORIS D. PLANT,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITIONERS' SUPPLEMENTAL BRIEF

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No. 82-1198

IN THE

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October Term, 1982

W. H. PLANT, JR. and DORIS D. PLANT,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITIONERS' SUPPLEMENTAL BRIEF

Petitioners in this case are seeking certiorari on the principal ground that a two-to-one decision of the Eleventh Circuit conflicts with decisions of this Court holding that payments received in advance of production do not prevent the retention of an "economic interest" for income tax purposes. This case was docketed on January 12, 1983; and two days earlier, on January 10, this Court granted certiorari in Docket No. 82-599, *Engle v. Commissioner,* 677 F.2d 594 (7th Cir. 1982), and Docket No. 82-774, *Farmar v. United States,* 689 F.2d 1020 (U.S. Cl. Ct. 1982). Those cases are bringing the very same issue before this Court and

involve the same decisions of this Court relied upon by the petitioners in this case. Therefore, in order for there to be consistent interpretation of these principles of federal income tax law, the Court should grant certiorari in this case also.

As stated in the petition for certiorari, the test for determining whether a taxpayer is entitled to percentage depletion on advance payments under an oil and gas lease is the same as the test for determining whether a taxpayer is entitled to capital gain treatment on advance payments under a timber cutting contract. In each instance, the test is whether or not the taxpayer has disposed of minerals or timber under a contract or lease in which he has retained an economic interest.

In *Engle* and *Farmar*, the question presented is whether the recipient of royalties or bonuses under an oil and gas lease is entitled to a deduction for percentage depletion with respect to advance royalties or bonuses paid when there is no production in that year.[1] In both cases, the courts below acknowledged that long-standing decisions of this Court allow depletion on payments made in advance of production, citing *Douglas v. Commissioner*, 322 U.S. 285 (1944); *Herring v. Commissioner*, 293 U.S. 322 (1934), and *Burnet v. Harmel*, 287 U.S. 103 (1932). The decision of the Eleventh Circuit in this case is in conflict with both *Engle* and *Farmar* as well as the decisions of this Court.

The history of income taxation of timber cutting contracts clearly shows that the economic interest test established by this Court is applicable to timber cutting contracts.

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[1]The Government is contending in *Engle* and *Farmar* that Congress changed the law with respect to advance payments in oil and gas leases when it enacted 26 U.S.C. § 613A in 1975.

The Treasury Department, relying on the decisions of this Court in the mineral cases, contended prior to 1943 that payments made under a timber cutting contract were the same as royalty payments under an oil and gas lease resulting in ordinary income subject to depletion rather than capital gain from the sale of timber. Bureau of Internal Revenue, Field Procedure Memo No. 249, Feb. 17, 1943. In reaching this conclusion the Treasury Department relied upon *G.C.M. 22730,* 1941-1 Cum. Bull. 214, which contains an analysis of the Supreme Court decisions in the oil, gas and mineral cases. These decisions hold that an economic interest is retained in minerals paid for in advance whether or not there is a guarantee of production in a later year.

As a result, Congress in 1943 enacted legislation providing for capital gain treatment on the disposition of timber pursuant to a cutting contract.[2] In so doing, it expressly adopted the concept of economic interest established by this Court in the oil, gas and mineral cases. Thus, the Senate Finance Committee stated that . . . "this . . . provision will afford relief to those who have leased their property under a contract whereby they retain an economic interest in the timber and are not entitled under present law to capital gains treatment because of that fact."[3]

It is absolutely clear that the test for capital gain treatment on the disposition of timber pursuant to a cutting contract is the same as the test for depletion under an oil and gas lease. This Court has held repeatedly for more than fifty years that an economic interest is retained even though payments are received in advance of production and without any guarantee of production. *Douglas v. Commis-*

[2] § 117 (k) (2) of the 1939 Internal Revenue Code, added by Sec. 127 (a) of the Revenue Act of 1943. However, no depletion is allowed, 26 C.F.R. § 1.611-1 (b) (2).

[3] Sen. Rep. 627, 78th Cong., 1st Sess., p. 25-26, 1944 Cum. Bull. 973, 993.

sioner, supra, Herring v. Commissioner, supra, and *Burnet v. Harmel, supra.* Therefore, since the test for capital gain treatment on timber and percentage depletion on minerals is identically the same, *i.e.*, whether the taxpayer has retained an economic interest, these decisions of the Supreme Court are determinative of the issue in this case.

CONCLUSION

The granting of certiorari in *Engle* and *Farmar* will bring before this Court the principles established by this Court in *Douglas v. Commissioner, supra, Herring v. Commissioner, supra,* and *Burnet v. Harmel, supra.* The two-to-one panel decision of the Eleventh Circuit in this case directly conflicts with those Supreme Court decisions. It also conflicts with the decisions in *Engle* and *Farmar* in which certiorari was recently granted. For this reason, a writ of certiorari should issue to review the judgment and opinions of the Eleventh Circuit.

Respectfully submitted,

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No. 82-1198

In the Supreme Court of the United States

OCTOBER TERM, 1982

W.H. PLANT, JR. AND
DORIS D. PLANT, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question presented in this federal income tax case is whether petitioners, who disposed of standing timber under a long-term cutting contract which does not oblige the other party to cut the timber, retained an economic interest in the timber under Section 631(b) of the Internal Revenue Code of 1954 (26 U.S.C.) with respect to minimum annual payments that they received in advance of cutting and are entitled to retain regardless of whether timber ever is cut. The decision below held that those payments did not represent a retained economic interest in timber and therefore were not eligible for capital gains treatment.

The stipulated facts may be summarized as follows: In February 1967, petitioners, W.H. Plant, Jr. and Doris D. Plant, entered into an agreement with the Hammermill

Paper Company, under which petitioners contracted to sell to Hammermill "all the timber standing and growing" on designated tracts during the 20-year term of the contract. The price, subject to adjustment according to the Wholesale Commodity Price Index, was $6.00 per cord for pine pulpwood and $2.50 per cord for hardwood. The agreement required Hammermill to pay for at least 2,000 cords of pine pulpwood per year, regardless of the actual annual harvest. The agreement also provided that Hammermill had no obligation to cut timber: [Hammermill] "shall be under no obligation to cut and remove any quantity of timber in any one year." If Hammermill cut more than 2,000 cords in any one year, the compensation for the excess was payable at the end of the year. In the event that Hammermill cut fewer than 2,000 cords during a year, a "timber backlog" clause authorized Hammermill to harvest the timber paid for in advance at any time prior to the expiration of the agreement. At the termination of the agreement, Hammermill's right to cut expires and petitioners may retain as "liquidated damages" any advance payments not credited against harvested timber (Pet. App. A-1 to A-2 & n.3, A-11 to A-12).

It is undisputed that during the years in suit — 1973 through 1975 — Hammermill cut no timber (Pet. App. A-2 & n.5, A-12). Nevertheless, by reason of its obligation to pay minimum annual payments, Hammermill paid petitioners $47,391.38. Petitioners reported this income as capital gains under Section 631(b) of the Internal Revenue Code of 1954. On audit, the Internal Revenue Service disallowed capital gains treatment on the ground that petitioners had not retained an economic interest in timber with respect to payments received in advance of cutting. It therefore determined that the payments were ordinary income (Pet. App. A-2, A-12).

In this refund suit brought by petitioners in the United States District Court for the Northern District of Alabama, the district court upheld the government's position that the payments in question were ordinary income. The court reasoned that the payments were not necessarily conditioned on the subsequent severance of timber because Hammermill was under no obligation to cut timber and petitioners were entitled to the advance payments whether or not timber was cut. The court therefore concluded that petitioners had failed, insofar as the payments at issue were concerned, to retain an economic interest in the timber as required by Section 631(b) (Pet. App. A-14 to A-15). The court of appeals affirmed on the authority of *Crosby* v. *United States*, 414 F.2d 822 (5th Cir. 1969) (Pet. App. A-5 to A-6).[1]

1. The decision below correctly held that petitioners were taxable at ordinary income rates on the minimum annual payments received from Hammermill under the timber contract.

Sections 631(b) and 1231(b)(2) of the 1954 Code (26 U.S.C.) (Pet. App. A-17 to A-18) provide that the disposal of timber "under any form or type of contract by virtue of which * * * [the] owner retains an economic interest in such timber" is to be treated as the sale of property used in the taxpayer's trade or business for purposes of Section 1231 of the 1954 Code (26 U.S.C. (& Supp. V)). Under Section 1231, the gains and losses on sales of property used in a trade or business are to be aggregated; if such sales show a net gain, that gain is treated as a capital gain. Thus, if the advance payments in question were attributable to a

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[1] In *Bonner* v. *City of Prichard*, 661 F.2d 1206 (1981), the Eleventh Circuit adopted the case law of the former Fifth Circuit as binding precedent (Pet. App. A-1 n.1).

retained economic interest in the timber, petitioners are entitled to capital gains; if not, they are subject to ordinary income rates.

Every court that has considered a timber cutting contract providing for advance payments, with no obligation imposed upon the payor actually to cut the timber, has ruled that with respect to the advance payments the taxpayer did not retain an economic interest in the timber. *Crosby* v. *United States*, 414 F.2d 822, 825 (5th Cir. 1969); *Superior Pine Products Co.* v. *United States*, 201 Ct. Cl. 455, 462-463, 481, cert. denied, 414 U.S. 857 (1973). See *Gammill* v. *Commissioner*, 62 T.C. 607, 619-620 (1974). These decisions are based upon the premise that an economic interest is retained only when the taxpayer possesses an interest in the property "to which he must look for a return of his capital." Treasury Regulations on Income Tax (1954 Code), 26 C.F.R. 1.611-1(b)(1). Accord, *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 314 (1956) (footnote omitted). Thus, in order for a taxpayer to retain an economic interest in timber, it is "essential" that the consideration "be contingent upon the severance of the timber, and payable to the owner solely out of the proceeds from the natural resource itself." *Dyal* v. *United States*, 342 F.2d 248, 252 (5th Cir. 1965) (footnote omitted). Accord, *Superior Pine Products Co.* v. *United States, supra*, 201 Ct. Cl. at 481.

Here, petitioners did not retain an economic interest in the timber with respect to the payments at issue because they were entitled to the advance annual payments whether or not Hammermill ever cut additional timber. Hammermill was not obligated to cut timber that had been paid for in advance, nor were petitioners required at the termination of the agreement to refund advance payments in excess of the value of timber harvested. In these circumstances, petitioners had no economic interest in the timber because they were not required to look to the timber for a return of their

capital. See W. Albritton, *Handling Timber Sales*, Fed. Taxes Oil & Gas Nat. Resources (P-H) paras. 1022, 1022.2 at 1484, 1022.4 at 1489 (June 28, 1979).

2. The decisions of this Court upon which petitioners rely (Pet. 5) are distinguishable because they involve the taxation of oil and gas, and not timber. To be sure, for years prior to 1975, taxpayers who received royalties or bonuses in advance of the production of oil and gas were eligible for the allowance for depletion with respect to those payments.[2] Such payments were treated as "payment in advance for oil and gas to be extracted." *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934). See *Burnet* v. *Harmel*, 287 U.S. 103, 111 (1932). Thus, a taxpayer receiving such payments was treated as retaining an economic interest in the oil or gas, with the result that such payments were eligible for the allowance for depletion. The lower courts, however, have consistently treated timber differently from oil or gas or hard minerals. As the Tax Court has observed, the courts have reached "overwhelming consistency * * * in cases dealing exclusively with timber contract rights * * *."

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[2]The Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501, 89 Stat. 47, changed the law with respect to the percentage depletion allowance for oil and gas, effective January 1, 1975. The question whether taxpayers who received advance royalties and lease bonuses that are not based on actual production during the taxable year may still claim percentage depletion for these payments is pending before the Court. *Commissioner* v. *Engle*, cert. granted, No. 82-599 (Jan. 10, 1983) and *Farmar* v. *United States*, cert. granted, No. 82-774 (Jan. 10, 1983).

Contrary to petitioners' suggestion (Supp. Pet. 1-2), *Engle* and *Farmar* do not present the "very same issue" presented here. Those cases turn entirely upon the correct application of the provision of Section 613A(c)(2)(A) of the 1954 Code, as added by Section 501(a) of the Tax Reduction Act of 1975 (89 Stat. 42), that requires the allowance for percentage depletion for oil and gas to be computed on the basis of the "average daily production * * * [during the] taxable year." Section 613A pertains only to oil and gas, and has no relevance to the taxation of timber.

Gammill v. *Commissioner, supra,* 62 T.C. at 620. Accordingly, in timber cases arising under Section 631(b), a taxpayer is not entitled to capital gains unless he is required to look to the severance of timber for annual payments due under a timber cutting contract. *Crosby* v. *United States, supra; Superior Pine Products Co.* v. *United States, supra; Dyal* v. *United States, supra.* See *Gammill* v. *Commissioner, supra,* 62 T.C. at 619-620. Cf. *Giustina* v. *United States,* 313 F.2d 710, 713-714 (9th Cir. 1962) (contrasting the lease of rights to explore for and extract oil and gas with the disposition of standing timber). Here, the advance payments were not necessarily attributable to the severance of timber because Hammermill was under no obligation to cut timber and petitioners were entitled to retain the advance payments whether or not timber ever was cut.[3]

3. The decisions of the courts of appeals upon which petitioners rely (Pet. 5) are likewise distinguishable because they are not timber cases arising under Section 631(b), but deal instead with the sale of sand and gravel or fill dirt. *Wood* v. *United States,* 377 F.2d 300 (5th Cir.), cert. denied, 389 U.S. 977 (1967); *Freund* v. *United States,* 367 F.2d 776 (7th Cir. 1966); *Laudenslager* v. *Commissioner,* 305 F.2d 686, 691 (3d Cir. 1962). The question presented in

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[3]Nor do *Douglas* v. *Commissioner,* 322 U.S. 275 (1944), or *Commissioner* v. *Southwest Exploration Co.,* 350 U.S. 308 (1956) support petitioners' position. The Treasury Regulations at issue in *Douglas* permitted percentage depletion in connection with advance payments made to lessors of mineral property, and the only question before the Court was whether the regulation was valid insofar as it required depletion deductions to be restored to income upon the expiration of the lease to the extent that minerals paid for in advance were not mined. See Treas. Reg. 94, § 23(n), art. 23(m)—10 (Revenue Act of 1936). Nor was any question involving the depletion allowance for advance payments involved in *Southwest Exploration Co.* The only question there was which taxpayer held a retained economic interest in certain oil, and therefore was entitled to the depletion allowance.

each of those cases was whether the owner of the deposits realized capital gains or ordinary income where the deposit was mined and paid for by another person. Significantly, in each case, the amount of mineral mined during the years in suit resulted in payment of more than the minimum annual royalties. *Wood* v. *United States, supra,* 377 F.2d at 302 n.3 and 303; *Laudenslager* v. *Commissioner, supra,* 305 F.2d at 688-690. See and compare, *Freund* v. *United States, supra,* 367 F.2d at 777 (minimum annual royalty of $12,000) with *Freund* v. *United States,* 17 A.F.T.R.2d para. 66-094 (N.D. Ill. 1966) (actual annual royalty payments exceeded $20,000 and $34,000, respectively). Thus, those courts did not consider the situation presented here, where payment was received in one year in connection with production to be undertaken, if at all, in the future. Thus, even on the assumption that sand and gravel cases are relevant, the question presented here could not have been presented in those cases.[4]

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[4]Petitioners erroneously contend (Pet. 7-8) that the decision below is contrary to Treasury Regulations on Income Tax, 26 C.F.R. 1.631-2(d) (Pet. App. A-20). Section 1.631-2(d)(1) provides that, when the conditions of Section 631(b) are otherwise met, advance payments for timber may qualify for capital gains treatment if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Section 1.631-2(d)(2) provides that advance payments, previously treated as capital gains, must be recomputed as ordinary income if the cutting contract expires, terminates or is abandoned before timber that has been paid for is cut. All that the decision below requires, however, is that a taxpayer be able to demonstrate that under the contract timber is required to be cut in return for advance payments. Even when a contract so provides, the possibility remains that the contract may expire or be abandoned with the obligation to cut remaining unsatisfied. In that event, the regulation requires that advance payments that are not attributable to harvested timber must be recomputed as ordinary income.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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